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Person To Contact:
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September 10, 2009

LEGEND

X	=	
z	=	
y	=	
C	=	
A	=	
H	=	
D	=	
$w	=	
B	=	
E	=	
F	=	
Number	=	
Date a	=	
Date b	=	
Date c	=	
Date d	=	

Dear :

This letter responds to your letter requesting certain rulings on behalf of X concerning the application of various sections of the Internal Revenue Code to transfers made by X to various escrow accounts. By letter postmarked May 14, 2009, the administrator of the escrow accounts joined X's request for these rulings.

FACTS

X is an S corporation engaged in the trade or business of manufacturing and wholesale distribution of y products, including z. X uses an accrual method of accounting and a taxable year that ends on December 31.

The Cs brought a consolidated suit against the major manufacturers and sellers (manufacturers) of y products, including z. The suit asserted various claims for monetary, equitable, and injunctive relief, including consumer protection and/or antitrust laws. X was not a party defendant in the suit brought by the Cs against the major manufacturers of y products.

On Date a, the Cs entered into a settlement agreement, A, to resolve litigation against the major manufacturers of y products. Under the A, the party defendant manufacturers of y products are required to establish escrow accounts and make annual payments (in perpetuity) into escrow for the benefit of the Cs. The A provides that all payments are in settlement of H. The party defendants' ongoing payments to the escrow accounts are determined by a formula based on their z sales. In exchange for these payments, the defendant manufacturers of y products are "absolutely and unconditionally released and forever discharged from all claims that the Cs directly, indirectly, derivatively or in any other capacity ever had, now have, or hereafter can, shall or may have" against the defendant manufacturers from liability relating to past, present, and certain future claims stemming from the use, sale, distribution, manufacture, development, advertising, or marketing of z. Under the A, these escrow accounts are expressly intended to be treated as qualified settlement funds for federal income tax purposes.

The party defendant manufacturers believed that the manufacturers of y products not named as party defendants in litigation also contributed to the harms alleged by the Cs. Consequently, the party defendant manufacturers of y products demanded as a condition of the settlement that nonparty manufacturers of y products be required to share the financial burdens and make deposits into escrows as well. The Cs agreed. In relevant part, the A directs the Cs to require that certain nonparty manufacturers, of which X is one, either opt into the A or establish escrow accounts based on the same formula as in the A. To accomplish this, each C has enacted the D which was incorporated into and made an integral part of the A approved by the court having jurisdiction.

The objective of the D is to force nonparty manufacturers who are not part of the A to assume a share of the financial burdens created by the use of z and other y products. The D applies to any nonparty manufacturer of y products selling z within a C. The amount of any manufacturer's annual deposits into the escrow accounts required by the D is based on the manufacturer's sales of z during the year in question. Any escrow accounts set up for this purpose must be approved by one of the Cs.

X has not opted into the A. Therefore, as a nonparty manufacturer of y products selling z within a C, X is required to establish escrow accounts under each C's D.

On or about Date b, X established the escrow accounts at B (which later became E), and thereafter opened escrow accounts at F, and began making annual deposits to the escrow accounts. As of Date c, X has deposited a total of $w in accordance with the above. As long as X remains a y product manufacturer selling z within a C, it will continue to be required to make annual deposits into such escrow accounts, based on its z sales, either at F or similar financial institutions. The escrow accounts exist to satisfy C claims brought against X within Number after the date such funds are placed into escrow. X may not access the funds for any purpose other than satisfying C claims during the Number period. Under D, any remainder will revert to X (reversionary interest) after those periods lapse.

X expects that claims for reimbursement for the costs of identical harms alleged by the Cs and settled under the terms of the A, will be made against all the contributed funds. If successful, the funds will be used to satisfy the C's claims, and nothing will remain to revert to X.

REQUESTED RULINGS

Escrow Account Classification

The first requested ruling is that the escrow accounts that X established pursuant to the A with B (which later merged with E) and F are qualified settlement funds within the meaning of § 1.468B-1 of the Income Tax Regulations.

Section 468B(g) provides, in part, that nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. Pursuant to the authority of section 468B(g), the Secretary has published §§ 1.468B-1 through 1.468B-5 regarding qualified settlement funds.

Section 1.468B-1(a) provides that a qualified settlement fund is a fund, account, or trust that satisfies all three requirements of § 1.468B-1(c). First, § 1.468B-1(c)(1) requires that the fund, account, or trust is established pursuant to an order of, or it is approved by, the United States, any state (including the District of Columbia), territory,

possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing and is subject to the continued jurisdiction of that governmental authority. Second, § 1.468B-1(c)(2) requires that the fund, account, or trust is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability (i) under the Comprehensive Environmental Response, Compensation and Liability Act of 1980; (ii) arising out of a tort, breach of contract, or violation of law; or (iii) designated by the Commissioner in a revenue ruling or revenue procedure. Third, § 1.468B-1(c)(3) provides that the fund, account, or trust must be a trust under applicable state law, or its assets must be otherwise segregated from other assets of the transferor (and related persons).

Section 1.468B-1(j)(1) provides that if a fund, account, or trust is established to resolve or satisfy claims described in § 1.468B-1(c)(2), the assets of the fund, account, or trust are treated as owned by the transferor of those assets until the fund, account, or trust also meets the requirements of § 1.468B-1(c)(1) and (c)(3). On the date the fund, account, or trust satisfies all the requirements of § 1.468B-1(c), the transferor is treated as transferring the assets to a qualified settlement fund.

Section 1.468B-2(k)(2) provides that a qualified settlement fund is in existence for the period that (i) begins on the first date on which the fund is treated as a qualified settlement fund under § 1.468B-1; and (ii) ends on the earlier of the date the fund (A) no longer satisfies the requirements of § 1.468B-1; or (B) no longer has any assets and will not receive any more transfers.

Based on the facts represented, on or about Date b, the escrow accounts established by X satisfied all three requirements of § 1.468B-1(c), and therefore are treated as qualified settlement funds as of the date established. First, with respect to § 1.468B-1(c)(1), the Cs are governmental authorities as the term is used in that context. Under the D provisions, each escrow account established by X must be approved by the C for which the account is established. The appropriate official of each C has the authority to monitor and pursue in court charges against X to enforce annual compliance with the D.

Second, with respect to § 1.468B-1(c)(2), under all the facts and circumstances, we are persuaded that X established the escrow accounts to resolve or satisfy contested or uncontested claims that have resulted or may result from a related series of events that has occurred and that has given rise to at least one claim asserting liability arising out of a violation of law. In this case, no formal complaint has been legally filed against X by any of the Cs. However, the absence of a formal complaint is not fatal to a determination that (1) the Cs have established the existence of the requisite claim or claims and asserted liability against X, and (2) the X has established the escrow accounts to resolve or satisfy said claim or claims.

With respect to (1), the event (or related series of events) that has already occurred is the development, manufacture, advertising, marketing, use, sale, and distribution of z, and other y products, which X sells. The claim that has already arisen is that a manufacturer of z is financially liable to reimburse the Cs for the costs associated with the harms related to the sale of z. Although X has not been named a party defendant to a suit filed by the Cs, the requirement of a suit asserting liability is not what the regulation requires. The regulation requires only that at least one "claim" asserting liability has resulted or may result. Each of the Cs has already made at least one claim asserting liability against each non-party manufacturer of z by enacting the D.

With respect to (2), it is also clear that X established and funded the escrow accounts to resolve or satisfy the claims (whether eventually contested or uncontested) made by the Cs. The objective of the D is to force nonparty manufacturers who refuse to opt into the A to assume a share of the financial burdens created by the harms allegedly caused by the use of z. Each C has a D, which applies to any nonparty manufacturer of y products selling z within a C. The amount of a manufacturer's annual deposits into the escrow accounts are based on a manufacturer's sales of z during the year in question. X is such a manufacturer and the amounts of its legally-obligated deposits are calculated on said basis. Therefore, even in the absence of a formally-filed legal complaint, the second prong under the regulation is satisfied.

Note that the facts in this case are distinguishable from Example 7 in § 1.468B-1(k) regarding a landfill operator. There a corporation owned and operated a landfill in a state that required the corporation to transfer money to a trust annually based on the total tonnage of material placed in the landfill during the year. Under the law, the corporation is required to perform (either itself or through contractors) specified closure activities when the landfill is full, and the trust assets would be used to reimburse the corporation for these closure costs. The trust in that example is not a qualified settlement fund because it is established to secure the liability of the corporation to perform such closure activities. The instant case does not involve a performance liability. The funds transferred to the escrow accounts under a D are not used to secure the future performance of X. To the contrary, the funds will be used to satisfy the Cs claims based on the past conduct of X; conduct that is related to known harm stemming from the use of z and that has given rise to known liabilities (e.g., increase in financial burdens on the Cs).

Third, with respect to § 1.468B-1(c)(3), the assets in the escrow accounts are otherwise segregated from other assets of X (and related persons). On or about Date b, X began establishing separate escrow accounts at B and F. Under the regulations, a separate bank account is sufficient to satisfy this requirement. See § 1.468B-1(h)(1).

Deduction for Payments to Escrow Accounts

The second and third requested rulings are (1) all payments made by X to the escrow accounts in Date d are fully deductible in Date d and (2) payments made by X to the escrow accounts after Date d are deductible in the year deposited into the accounts.

Section 162(a) of the Code provides the general rule that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. See also § 1.162-1(a).

Section 461(a) provides, in part, that the amount of any deduction shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) provides, in part, that under an accrual method of accounting, a liability is incurred, and generally taken into account for federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 461(f) provides that if (1) the taxpayer contests an asserted liability, (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability, (3) the contest with respect to the asserted liability exists after the time of the transfer, and (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after application of § 461(h), then the deduction shall be allowed for the taxable year of the transfer.

Section 461(h)(1) provides, in part, that in determining whether an amount has been incurred with respect to any item during the taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

Section 461(h)(4) provides that the all events test is met with respect to any item if all events have occurred which determine the fact of the liability and the amount of such liability can be determined with reasonable accuracy.

Section 1.468B-3(c)(1) provides that for purposes of § 461(h), economic performance occurs with respect to a liability described in § 1.468B-1(c)(2) to the extent the transferor makes a transfer to a qualified settlement fund to resolve or satisfy the liability.

Section 1.468B-3(c)(2) provides that economic performance does not occur to the extent (A) the transferor (or a related person) has a right to a refund or reversion of a transfer if that right is exercisable currently and without the agreement of an unrelated person that is independent or has an adverse interest (e.g., the court or agency that

approved the fund, or the fund claimants), or (B) money or property is transferred under conditions that allow its refund or reversion by reason of the occurrence of an event that is certain to occur, such as the passage of time, or if restrictions on its refund or reversion are illusory.

Section 1.468B-3(f)(1) provides that a transferor must include in gross income any distribution it receives from a qualified settlement fund.

Section 1.468B-3(f)(3) provides that a distribution described in § 1.468B-3(f)(1) or (f)(2) is excluded from the gross income of a transferor to the extent provided by § 111(a) (regarding the recovery of tax benefit items).

Based on the above, the amounts transferred into escrow accounts will be used to pay money damages to the Cs for liabilities that arose as a result of X's principal business activity, that is, the manufacture and sale of z and other y products. Thus, such amounts are deductible under § 162(a) as ordinary and necessary business expenses. To the extent that the all events tests under § 1.461-1(a)(2), including economic performance, are met, the amounts transferred into the escrow accounts would be deductible in the taxable year transferred. In this case, the first prong of the all events test, i.e., all the events have occurred that establish the fact of the liability, is met because this is a contested liability within the meaning of § 461(f). Likewise, the second prong, i.e., the amount of the liability can be determined with reasonable accuracy, is met because the amount of the liability can be readily ascertained based on the formula prescribed by the D. Finally, under § 1.468B-3(c), transfers to a qualified settlement fund to resolve or satisfy claims for which it is established constitute economic performance.

In addition, under the facts presented and representations made, the fact that D provides for a reversion of monies if any remain after Number from the date of the transfers does not prevent economic performance from occurring. The D provides that the monies transferred into the escrow accounts revert to X after Number from the date of the transfers if the Cs have not filed and prevailed on claims either by obtaining a judgment against, or a settlement with, X. The funds exist to satisfy C claims brought against X within Number after the date monies are transferred into the funds. X may not access the funds for any purpose other than satisfying C claims during the Number period. X expects that claims will be made against all the assets of the funds and, if successful, the funds will be used to satisfy C claims and that nothing will remain to revert to X. There is no guarantee and little likelihood that any amounts will revert to X after Number. The reversion in this case requires not only the passage of time, but also the successful defense against claims brought by the Cs before anything reverts to X. Although the passage of time (i.e., Number) is certain to occur, it is clearly uncertain whether the Cs will neither file nor prevail on claims against X. Thus, the payments are not transferred under conditions that allow their refund or reversion by reason of the

occurrence of an event that is certain to occur. Finally, X does not have a currently exercisable right to a refund or reversion.

Therefore, we conclude that (1) all payments made by X to the escrow accounts in Date d are fully deductible in Date d and (2) payments made by X to the escrow accounts after Date d are deductible in the year deposited into the accounts. However, to the extent X receives any distributions from the escrow accounts, e.g., overpayments, refunds, interest, or other appreciation on the funds, X must include such amounts in its gross income.

Tax Rate Applicable to Escrow Accounts

The fourth requested ruling is that each escrow account is subject to tax on its modified gross income for any taxable year at a rate equal to the maximum rate in effect for that taxable year under § 1(e).

Section 1.468B-2(a) provides, in relevant part, that a qualified settlement fund is subject to tax on its modified gross income for any taxable year at a rate equal to the maximum rate in effect for that taxable year under § 1(e).

Based upon the facts presented and representations made, and given the conclusion above that the escrow accounts are qualified settlement funds within the meaning of § 1.468B-1, we conclude that each escrow account is subject to tax on its modified gross income for any taxable year at a rate equal to the maximum rate in effect for that taxable year under § 1(e).

Transfer by X to Escrow Accounts Excluded from Accounts' Gross Income

The fifth requested ruling is that transfers by X to the escrow accounts will not constitute gross income to the accounts.

Section 1.468B-2(b) provides that, in general, the modified gross income of a qualified settlement fund means its gross income as defined in § 61, computed with the modifications provided in § 1.468B-2(b)(1)-(4). In general, under § 1.468B-2(b)(1), amounts transferred to the qualified settlement fund by, or on behalf of, a transferor to resolve or satisfy a liability for which the fund is established are excluded from gross income. However, dividends on stock of a transferor (or a related person), interest on debt of a transferor (or a related person), and payments in compensation for late or delayed transfers, are not excluded from gross income.

Based on the facts presented and representations made, amounts transferred by X to the escrow accounts are made to resolve or satisfy a liability for which the escrow accounts are established (i.e., the increase in financial burdens on the Cs). Therefore,

we conclude that transfers made by X to the escrow accounts will not constitute gross income to the accounts.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to X's authorized representatives.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Kathleen Reed

Kathleen Reed
Branch Chief, Branch 7
(Income Tax & Accounting)

cc: